Stranded Gas Hearings

(0406161500 Minutes)

Range of Permissible Tariff Methodologies

Robert "Bob" Loeffler, Senior Partner, Morrison & Foerster, June 16, 2004.

ROBERT LOEFFLER, Senior Partner, Morrison & Forrester, LLP, offered the following:

> Before I get to the assigned topic, I want to pick up on the Senator's last question. I had the privilege - or "misprivilege" - in 1974 or [1975] of going to the first of 18 months of hearings on the Alaska gas pipeline. To give you an idea of the speed of FERC at the time, it took one day and a half for all the attorneys to enter their appearances - that was just the token. Because of that, Congress intervened before to pass legislation - the Alaska Natural Gas Transportation Act of [1976] - and, indeed, the federal energy bill, and there's consensus on the so-called enabling provisions, provide essentially for a two-year process.
>
> Indeed, FERC is required to grant the certificate within 60 days, the completion of the impact statement. So if that legislation passes, Congress has provided a solution to what otherwise can be a slow process; if the legislation does not pass, [the] FERC has taken steps to improve the process from the late 1970s - much needed steps. ...

MR. LOEFFLER turned to the range of permissible methodologies that the FERC might apply in setting tariff rates for an Alaska gas pipeline. He specified that he is going to speak generally about the methodology and standards the FERC uses to set gas pipeline rates. He pointed out that in the appendix, there is material from a sample rate case at FERC. There is also a hypothetical illustration and a range of results in a large number of recent FERC cases that will provide some parameters. However, with Alaska everything's a little bit different, which is also true [with regard to how] FERC [deals with Alaska]. The magic standard is that of ANGTA and many other regulatory statutes, which is that the rates have to be just and reasonable. However, there's a lot of flexibility in those standards. He recalled when TAPS started operation, there was a huge controversy regarding the proper way to set the rates on TAPS and that controversy continues to this day. The good news is that gas pipeline rates are set on [a] standard utility ratemaking basis, which is "original cost" ratemaking. Still, there are a lot of details, which have some real dollar consequences with regard to what happens in Alaska.

MR. LOEFFLER emphasized that there are different regulatory regimes for oil pipelines and gas pipelines. For oil pipelines, dual jurisdiction exists. Therefore, the Regulatory Commission of Alaska (RCA) sets rates for shipments inside Alaska while FERC sets rates for shipments that go into interstate commerce. However, for gas pipelines FERC sets the rate for the gas that goes from Prudhoe Bay outside Alaska, and the rate for any gas that's taken off in Alaska, as long as that gas travels on the main pipeline. Mr. Loeffler remarked that the committees have probably noticed a relative absence of discussion related to the role of the RCA [because its] role will not correspond to what it was for the oil pipeline. He noted that "there's established [U.S.] Supreme Court law on that: ... once the FERC is in there, it's in there comprehensive on any rate that goes for the main pipeline, whether that gas is taken off inside or outside Alaska. There's a second consequence: for an oil pipeline to go into business or to exit the business, you do not need permission from the FERC, [but] for a gas pipeline you do." When TAPS started out, the FERC didn't have any process that corresponds to what there will be for the gas [pipeline]. For gas pipelines, one applies to FERC, which regulates the size and pressure of a gas line as well as whether it serves the public interest. Furthermore, [FERC] has a huge environmental impact process. "It's a comprehensive form of regulation," he remarked.

MR. LOEFFLER specified that gas pipeline regulation is the "bread and butter" of what the FERC does. "They really don't like to do very much with oil pipelines, which was one of the problems," he commented. Therefore, one must remember this framework when thinking about fighting the last war, which is the TAPS war, and fighting the wars that are to come on the gas [pipeline]. Mr. Loeffler pointed out that the [U.S.] Supreme Court has said that the FERC has very broad discretion in ratemaking; there's no single formula or combination of formulae for determining just and reasonable rates, although the original cost is the overarching thing. However, that's not true for oil pipelines, and therefore, again, there's a difference

in the two.

MR. LOEFFLER remarked that the objective is to strike a balance between rates that protect consumers from excessive rates, and those that reward investors for the risks of investing in the pipeline. In the [Hope Natural Gas] case, the [U.S.] Supreme Court teaches that the rates should attract capital to the regulated enterprise and allow it to earn what other projects facing the same risk do. Furthermore, rates are set "in the first instance" by the pipeline rather than FERC. Therefore, the pipeline puts out a set of proposals and will file proposed rates in the open season. The FERC reviews [those], and certainly the pipeline cannot depart wildly from FERC precedent in figuring out what the rates are. Again, one must remember that there's considerable leeway in how a project will design and negotiate its rates with its proposed shippers. Mr. Loeffler returned to a point that Mr. Ives made regarding when the FERC approves the facilities. When FERC grants a certificate of public convenience and necessity, it does a mini rate review. He explained that FERC expects to have a rate case sometime [in the future], and therefore rates are set in line with FERC precedent. However, there's a lot of discretion in that FERC precedent and one doesn't get to litigate rates until later in the process.

MR. LOEFFLER turned to the details in setting rates, and said that it's basically a cost-plus system. The rates are designed to recover the operating costs, depreciation, taxes, and return on capital investment. This process is called, "calculation of a cost of service, or revenue requirement." He mentioned the revenue requirement set forth in appendix A. He explained that the rates are designed to allow a pipeline to recover all the costs as well as an opportunity to earn a return on the invested capital. However, most of the energy in ratemaking is spent on the following three things: determining the return/profit component; the depreciation; and the rate design. He explained that the rate of return calculation is basically one in which the commission is trying to determine the "overall cost of capital" the enterprise should receive. In order to determine the return, the cost of capital is multiplied by the rate base, which is the property devoted to public utility service. The rates are designed to capture all that return, he noted.

MR. LOEFFLER moved on to steps [necessary to achieve a rate]. He turned to [one of the steps] the capital structure of the asset, that is the percentage of the asset that is debt and the percentage that is equity put in by the investors. Once that's determined, the cost of each class of asset must be determined. He remarked that it's fairly easy to determine the amount of debt of a pipeline. Preferred stock goes into debt, he noted. Mr. Loeffler explained that to determine the return on equity, the earnings of other pipelines in the industry are reviewed and used to set up a proxy or standard. After the pipeline entity argues about what [constitutes] the right proxy group, the right year, and the right factors, then a proxy reference point is established. A proxy reference point is really a range of returns. However, then the pipeline entity argues that it's not an average pipeline, but rather more risky and thus deserves more. The shippers, on the other hand argue that the pipeline entity isn't risky at all and thus the pipeline entity should earn less. "That's the nature of the fight," he said. The FERC, since at least 1998, has used this discounted cash flow methodology, which is referenced on page 9 and in appendix B. The proxy idea is to review what investors in pipeline stocks expect to earn. The FERC has gone to a method that is sort of front-weighted, which places more weight on recent earnings than long-term earnings because everyone's more anxious to earn money these days.

MR. LOEFFLER maintained that selection of the proxy group is not a science: there's a lot of argument that goes into how you do it. Appendix [C] is a list of about 60 cases, which highlights that the rate of return on equity has ranged from 12.38 percent to 14 percent. Mr. Loeffler said he expected there could be some point of contention between the state and any pipeline project regarding what is considered the appropriate rate of return on equity. He pointed out that in the early 1980s, when the Alaska gas pipeline last made its way through the FERC, it created an incentive rate of return mechanism to try [to] control costs. The center point of that was a 17.5 percent rate of return on equity. However, that was during a time when all returns were at [a] historic high; long-term U.S. government bonds were at 15 or 16.25 percent. Although that's not today's environment, it's one reference point that he was sure someone will mention. He recalled that in the TAPS rate case, there were many arguments that it was the "first of it's kind, cold and dark, it deserved a particular sort of return." Mr. Loeffler said that when FERC analyzes the risk, it looks at various types of risk such as the risk during the construction period, the operating period,

and the financial risk relating to capital structure. The aforementioned is reviewed in order to determine the right number for the risk. Whether the project is [project] financed or financed off the balance sheet is important when determining the correct rate of return or the overall return on capital for a pipeline. Mr. Loeffler explained that project finance means that it's essentially the earnings from the pipeline that will support the debt. Project financing is very common in real estate as well as in pipeline projects.

MR. LOEFFLER explained that typically a project-financed pipeline will borrow 70-80 percent of the cost of a project. The last time the gas pipeline went through, it was a "75 percent debt:25 percent equity" structure, he noted. He related that debt almost always costs less than equity. Therefore, if one has a lot of debt in the capital structure, the amount of the return that is assigned to debt is large and the overall amount of the return is less. On the other hand, if one has a huge amount of equity, it receives a higher rate of return, which "tends to drive up a pipeline." In reviewing pipelines that weren't project financed recently, one finds capital structures in the industry of 50 or 60 percent equity, which isn't atypically. However, in reviewing project finance, one finds much less. Although there's no universal rule as to what's acceptable, it makes a big difference in the return element. Therefore, a critical decision to ask is, how will these projects be financed: project financed with a lot debt; or financed on a recourse basis with a lot of equity?

MR. LOEFFLER addressed the question regarding how FERC decides whether a capital structure is appropriate, that is whether it has too much debt or too much equity. Basically, FERC reviews how the project was actually financed. [If the project was] financed, hypothetically, at the parent company level, as opposed to the pipeline company level, then FERC will say maybe it's the parent company's capital structure that should be used. However, FERC reviews whether the debt was reasonable. He noted that FERC prefers actual as opposed to hypothetical capital structures. With a hypothetical [capital structures], "it would have to construct what it thinks the world should be as [opposed] to what it is." Although FERC does this sometimes, it's rare. Now, when you actually go through the math, which this does, it's sort of interesting because what I did was take a hypothetical pipeline - million-dollar pipeline - and I have three cases.

MR. LOEFFLER directed attention to a comparison chart, which utilizes three cases for a hypothetical pipeline. The project-financed pipeline is three-quarters debt with lots of money borrowed from the bank. For the equity-rich pipeline he proposed that it's a very large, worldwide oil company worth a lot of money and with very little debt. He also proposed hypothetically that two of the three companies on the North Slope are in this position of being an equity-rich pipeline with only 10-20 percent debt. He explained that he assigned the project-financed project slightly different equity numbers because the FERC tends to look at such a project as riskier than [an equity-rich pipeline project] with the equity of a very rich company behind it. He explained that [the chart] uses the same cost of debt. Therefore, the return, which goes into the rate with the costs and depreciation, before accounting for interest on the project-financed pipeline, is $95,000. However, the [return for] the middle of the road pipeline is "about [$]105 and [$]104." Still, one has to deduct, from that return element, all the money necessary to pay for the bonds. Therefore, one finds [that] the equity-rich pipeline brings much more money home to the parent company than the project-financed pipeline. However, one must [remember that] in one case [the pipeline owner/investors] used 80 percent of their own money whereas in the other case [the project-financed pipeline owner/investors] borrowed three-quarters of the money from the bank. "So they're the two polar extremes, and that's the point of my illustration," he said.

MR. LOEFFLER directed attention to a chart that follows his prepared statements; it lists many rate cases. He said that one must not take too much comfort in this long list of cases because Alaska is the largest project to go through FERC, "and it will set it's own rules." The cases are sorted by whether the pipelines were project financed or not project financed. Therefore, one can see, in the last column, that most of the project-financed pipelines have an overall cost of capital around 10 percent. The chart further relates the pipelines that were not project financed but rather financed off the balance sheet of their owners have a higher return "on that." Although one would have to adjust for the time of the case and the particular circumstances of the corporation, it's illustrative of how the process works at FERC [and] the advantages of project financing.

MR. LOEFFLER turned to the question of why wouldn't everyone with the resources put 80 percent of the equity in the project. He explained that in unregulated businesses, many companies don't view 14 percent return on equity, which is about as high as the FERC has awarded in any of these cases, is not as good as they can do with other investment of their money. Therefore, some may prefer a project-finance route and thus tie up as little money as possible in this project.

MR. LOEFFLER said he needed to make a few corrections to his testimony. He provided the following qualification: "pipeline companies are allowed to earn this return after taxes, so there's a step that I omitted." A tax allowance or tax gross-up (ph) is added on top of the amount of the return so that after tax, on a hypothetical stand-alone basis, the amount earned is the identified return. "And there are a lot of dollars involved in that," he remarked. He then commented on open seasons as they apply to this pipeline and the [Congressional] legislation that provides that FERC will adopt open season regulations for this project, although normally there hasn't been anything that resembled detailed, open season regulations. He pointed out that although there are a lot of FERC rulings, they occur after the pipeline arrives when someone complains that the open season was unfair or performed incorrectly. If this legislation is passed, he predicted that FERC would be more proactive. The FERC will be required to adopt the set of regulations within 120 days of the legislation governing open seasons for this pipeline, and therefore there will be regulations in advance of open seasons for this pipeline. He noted that there are other provisions of the enabling legislation that address such issues as expansions, lateral service in Alaska, et cetera.